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In the Supreme Court of the United States

OCTOBER TERM, 1965

No.

UNITED STATES OF AMERICA, PETITIONER

v.

JOHN CATTO, JR. AND ROXANA CATTO

UNITED STATES OF AMERICA, PETITIONER

v.

W. H. WARDLAW, Independent Executor of the Estate of C. W. Wardlaw, Deceased, et al.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of the United States, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Fifth Circuit in the above-entitled cases.

OPINIONS BELOW

The district court did not file an opinion. Its findings of fact and conclusions of law in *United States*

v. *Catto* (R. 38-49),[1] are reported at 223 F. Supp. 663, and in *United States* v. *Wardlaw* (R. 3-20) at 223 F. Supp. 631. The respective *per curiam* opinions of the colurt of appeals (Appendix A, *infra*, pp. 18-21, 23-25) are reported at 344 F. 2d 227 and 344 F. 2d 225.

JURISDICTION

The judgments of the courts of appeals were entered on April 8, 1965 (Appendix A, *infra*, pp. 22, 26). Mr. Justice Black extended the time for filing a petition for a writ of certiorari to and including September 5, 1965. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

Ranchers are, in general, entitled to capital gain on profits from the sale of breeding livestock which they use to produce animals marketed for purposes of slaughter. Long-standing Treasury Regulations require taxpayers who (like those involved in the instant cases) follow one of the variants of the accrual method of accounting to capitalize the costs of raising breeding livestock and then to report as capital gain the excess of the animals' sales proceeds over their cost basis. The taxpayers consistently complied with these regulations, but subsequently brought suits for refunds claiming the right (1) to deduct against ordinary income all of the costs of raising their breeding animals, thus giving them a zero cost basis in the

[1] "R." references are to the printed records in the court of appeals.

livestock and (2) to report the full proceeds of sale as capital gain. The questions presented are:

1. Whether, contrary to Treasury Regulations which the court below held invalid, ranchers using the unit-livestock-price variation of the accrual method of accounting may transform ordinary income into capital gain by deducting against current income the accumulated cost (basis) of raising breeding livestock and then reporting the entire proceeds from their sale as capital gain.

2. Whether a court may permit taxpayers to revise materially their consistent method of reporting income by adopting a hybrid system when those taxpayers did not first make application to the Commissioner for permission to change their method of accounting as required by the Internal Revenue Code of 1954, § 446(e).

STATUTES AND REGULATIONS INVOLVED

Sections 446(e), and 1231(a) and (b)(3) of the Internal Revenue Code of 1954, and Sections 1.61-4, 1.162-12, 1.167(a)-6(b), 1.446-1(e)(2)(i), and 1.471.6 of the Treasury Regulations (1954 Code), appear in Appendix B, *infra*, pp. 36-44.

STATEMENT

The pertinent facts in both suits were stipulated and are substantially the same. For the most part, it will be unnecessary to distinguish between them. The taxpayers are ranchers who raise livestock for

sale.[2] As an incident of this business they also raise breeding cattle which they use to produce beef animals. Each of the taxpayers elected to report his income on a variant of the accrual method of accounting, called the unit-livestock-price method. This method (as explained in more detail, *infra*) permits the taxpayer to use estimates in lieu of the actual cost of raising cattle for purposes of valuing cattle on hand at the end of the tax year. As required by the Regulations, the taxpayers consistently used this estimated-cost method of accounting for both the beef and breeding cattle which they raised. (Catto R. 40; Wardlaw R. 8, 10.)

During the years here in question taxpayers sold some animals which they had held for breeding purposes for more than 12 months and reported the profit as capital gain under Section 1231 of the 1954 Code. They computed the gain on these sales by deducting from the sales proceeds the cost basis of the breeding cattle sold (calculated according to the taxpayers' estimated-cost method of accounting). However, the taxpayers thereafter filed claims for refund, contending that they should not have capitalized the cost of

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[2] Eight cases were consolidated for trial in *United States* v. *Wardlaw;* that case and *United States* v. *Catto,* have been consolidated herein. The years involved vary from case to case, but cover 1954 through 1959, inclusive (Catto R. 39; Wardlaw R. 7). The various taxpayers raise cattle, sheep and goats (Catto R. 40; Wardlaw R. 8). The legal principles are the same regardless of which animals are involved. For simplicity, this petition will refer to them all as cattle; and the term "beef cattle" will be used to mean livestock which are marketed for purposes of slaughter.

raising their breeding cattle. They argued (1) that the entire accumulated cost of the breeders should be deducted against ordinary income, thus giving them a zero cost basis in the cattle, and (2) that the entire proceeds from the sale of the cattle should be capital gain. At no time, however, did any of the taxpayers request the Commissioner's permission to change their method of accounting. The Commissioner rejected the refund claims. (Catto R. 43-45; Wardlaw R. 12-13.) The taxpayers then sued for a refund and the district court rendered judgment in their favor (Catto R. 50; Wardlaw R. 1, 20, 140). The Fifth Circuit affirmed *per curiam* on the authority of its earlier decision in *Scofield* v. *Lewis*, 251 F. 2d 128 (App. A, *infra*, pp. 27-35), and held invalid the Treasury Regulation requiring accrual basis ranchers on the unit-livestock-price method of accounting to accumulate the estimated cost of raising breeding cattle (App. A, *infra*, pp. 20-21, 23-24).

REASONS FOR GRANTING THE WRIT

1. The Fifth Circuit's decisions in the instant cases are in direct conflict with decisions of the Courts of Appeals for the Eighth and Ninth Circuits. *United States* v. *Ekberg*, 291 F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920, and *Little* v. *Commissioner*, 294 F. 2d 661 (C.A. 9).[3]

The first case decided on the point involved in the instant cases was *Scofield* v. *Lewis*, 251 F .2d 128,

[3] See also *Irvine* v. *United States*, 212 F. Supp. 937 (D. Wyo.); *Frost* v. *Commissioner*, 28 T.C. 1118.

in which the Fifth Circuit held against the government. However, shortly thereafter the Fifth Circuit cast doubt on the validity of its own *Lewis* holding by stating that "the principle of the *Lewis* case should not be extended beyond its own facts." *Carter* v. *Commissioner*, 257 F. 2d 595, 600. When the Eighth and Ninth Circuits thereafter held for the government on the same issue, we successfully opposed certiorari on the ground, *inter alia*, that the Fifth Circuit's view was in doubt. The instant decisions of the Fifth Circuit, however, remove all question as to the existence of a clear and direct conflict. Unless the conflict is resolved, ranchers in the Eighth and Ninth Circuits will be taxed differently from the vast number of livestock raisers located in the Fifth Circuit.

2. The instant decisions erroneously held invalid a Treasury Regulation of long standing.

Most ranchers, in addition to raising beef cattle, raise breeding cattle which, when they reach maturity, are used to produce the rancher's beef cattle. The Internal Revenue Code treats the beef cattle like the inventory of a manufacturing concern; the rancher thus pays an ordinary income tax on the profits from their sale. Breeding cattle, however, are generally not held for sale to customers but are used by the taxpayer in producing property (*i.e.*, beef cattle) to be sold to customers; thus, gain from the sale of breeders, like profit on the sale of plant and machinery, is taxed as capital gain. Internal Revenue Code of 1954, § 1231(a), (b)(3), App. B, *infra*, pp. 36-37.

The Treasury Regulations attempt to give ranchers (and farmers) the widest possible choice between a simplified method of computing gains (the cash receipts and disbursements basis) and a more sophisticated method of accounting (the accrual basis). Treas. Reg. § 1.471-6, App. B, *infra*, pp. 41-44.[4] If a rancher selects the accrual system, he is required by the Regulations to maintain an inventory of cattle on hand and to capitalize the cost (or estimated cost) of his breeding and beef herds. Treas. Reg. § 1.61-4(b), App. B, *infra*, pp. 38-39. Because of the complexities of the cattle industry, the Regulations give an accrual basis rancher a number of alternative ways to value his livestock on hand at the beginning and end of his tax year. Treas. Reg. § 1.471-6(c), (h), App. B, *infra*, pp. 41-43. The valuation of cattle on hand is crucial to the computation of profit or loss: To the extent that the value of cattle on hand at the end of the tax year has increased from the beginning of the year, expenditures for feed, etc. are not currently deductible but are capitalized and thus increase the taxpayer's cost basis in the cattle. Treas. Reg. §§ 1.61-4(b), 1.162-12, App. B, *infra*, pp. 38-39. The cost basis (as annually augmented by those expenditures which are not currently deducted) is then used to determine gain on sale of the animals, which in the case of breeding cattle held for at least 12 months constitutes capital gain. Internal Revenue Code of 1954, §§ 1011-1013, 1016, 1231. For example, assume that a rancher's cattle on hand at the

[4] Citations to the Treasury Regulations are to those promulgated under the Internal Revenue Code of 1954.

beginning of the year were valued at $100, that he expended $100 in raising his animals during the year, and that his unsold cattle at the end of the year were valued at $140. Since his inventory increased in value by $40, $40 of the $100 expended during the year would be nondeductible, *i.e.*, it would be added to the cost basis of his cattle on hand (capitalized). The other $60 (the costs of raising the cattle which were sold) would be deducted from the proceeds of sale to determine gain (capital or ordinary, depending on the type of animals sold).

Because it is extremely difficult as a practical matter for a rancher to accurately allocate his costs among his various operations, the Regulations permit (but do not require) him to elect a special method of estimated-cost accounting, called the "unit-livestock-price" method. Treas. Reg. § 1.471-6(c). Its purpose is to reach the same approximate result as an actual cost method, but to use a series of estimates in order to simplify the required record keeping and allocation tasks. All of the taxpayers involved in the instant cases were on the unit-livestock-price variation of the accrual method of accounting (Catto R. 40; Wardlaw R. 10). Under this method the taxpayer estimates the amount it costs him to raise his cattle to various stages of development and establishes a "standard unit price" for each class of animal. At the end of each tax year he counts the number of head on hand in each category and values them according to his established estimates (which remain constant from year to year). Treas. Reg. § 1.471-6(e), (f), (h). Then the taxpayer takes a deduc-

tion on his tax return for all expenses incurred during the year in raising his cattle but reduces this deduction by (*i.e.*, adds to income) the increase in the value of his cattle on hand at the end of the year over his cattle on hand at the beginning of the year, both valued according to the estimated-cost method. Treas. Reg. §§ 1.162-12, 1.61-4(b). If the taxpayer has chosen accurate estimates of his costs, this method will produce the same result as using actual costs.

For an illustration of this method as it works with respect to beef cattle, assume that a taxpayer estimates that it costs him $10 per year to raise an animal. Assume, also, that at the beginning of the year he had on hand 10 one-year olds, that he expended $100 in raising his animals during the year, and that just before year end he sold three, so that at the end of the year he still owned 7 two-year-olds. The value of his cattle at the beginning of the year was $100 (10 x $10). The value of his cattle at the year end was $140 (7 x $20). His inventory increased in value by $40, so $40 of the $100 expended during the year would be capitalized and the other $60 would be deducted from ordinary income. The $60 deduction comprises both the cost basis at the beginning of the year of the three head sold (3 one-year olds at $10) and the $30 spent on them during the year. The $140 of cattle still on hand is composed of $70 from opening inventory (7 one-year olds at $10) plus the $70 spent on them during the year.

The Regulations provide that if a taxpayer chooses to use the unit-livestock method of accounting he must use it consistently for both his beef animals and his

breeding herd. Treas. Reg. § 1.471-6(f). Thus as the rancher raises a breeder he accumulates his estimated costs; and when he sells an animal which has become too old to be useful in breeding, he uses the accumulated estimated cost of raising the animal as his basis for computing capital gain.[5] Internal Revenue Code of 1954, §§ 1011-1013, 1016. For example, if the taxpayer has estimated that it costs $100 to raise a breeder to maturity, $100 of his expenditures is capitalized as the cost basis of the animal (*i.e.*, $100

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[5] In general the Treasury Regulations permit accrual basis ranchers to depreciate either purchased or raised breeding cattle used in their trade or business. Beginning with a breeding animal's maturity a rancher, under generally accepted principles, is permitted to depreciate the excess of its cost basis over its estimated salvage value. Treas. Reg. §§ 1.61-4(b), 1.167(a)-6(b), App. B, *infra*, pp. 38, 40. However, because breeding animals can be sold for their beef value at the end of their useful lives as breeders, the cost of raising a breeding animal almost always approximates or is less than its estimated salvage value. This is especially true of those taxpayers who use the unit-livestock-price method of valuing their cattle; standard unit costs (used to value cattle on hand) have remained constant over the years while actual costs and salvage values have risen because of inflation. Thus as a practical matter only purchased breeders (for which thousands of dollars are sometimes paid) are depreciable, and raised breeders (for which at most a few hundred dollars of raising costs were expended) are not. This explains the requirement that a rancher who elects the unit-livestock-price method of accrual accounting must "inventory" his raised breeding cattle on the unit-livestock-price method of valuation (see Treas. Reg. §§ 1.471-6(f), (g), 1.162-12; Mim. 5790, 1945 Cum. Bull. 72). The designation "inventory" merely prevents him from depreciating raised breeding cattle, which as a practical matter he could not depreciate anyway, and has no other effect.

of his expenditures is not deducted as incurred); if the animal is ultimately sold for $150, the taxpayer recognizes a $50 capital gain on sale.[6]

The Fifth Circuit in the instant cases did not disagree with the Commissioner's contention that these Regulations were a logical and reasonable method of taxing accrual basis taxpayers. Rather, the court held that the Regulation was invalid because it did not afford accrual basis ranchers the same windfall that cash basis taxpayers receive (App. A, *infra*, pp. 20-21, 24). The Regulations permit a cash basis rancher to deduct annually all of his expenses of raising both beef and breeding cattle. He is not required to maintain any inventory or to capitalize any of his costs. Treas. Reg. §§ 1.162-12, 1.61-4(a), App. B, *infra*, pp. 37-38, 39. Thus a rancher on the cash method of accounting has a zero cost basis for his animals, and when he sells a breeder the full proceeds of sale are capital gain. He obtains an unwarranted tax advantage by deducting from ordinary income the cost of raising a breeding animal and reporting as capital gain the resulting increase in profit on sale of the zero-basis animal. For example, if we assume that it costs $100 to raise a

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[6] Since opening inventory includes both breeding and beef cattle and since opening inventory is in effect deducted from income, those breeders which have been sold must be removed from opening inventory in order to avoid a double deduction: Once in computing the amount of capital gain and again in computing ordinary income. *Gibbs* v. *Commissioner*, 33 T.C. 27; *Little* v. *Commissioner*, 34 T.C. 156, affirmed, 294 F 2d 661 (C.A. 9).

breeder which is ultimately sold for $150 after it has outlived its breeding utility, an accrual basis rancher would have a capital gain of $50. A cash basis rancher, on the other hand, would deduct the $100 of raising costs against ordinary income as incurred and would then have a $150 capital gain upon sale. Thus the cash basis taxpayer (as compared to the accrual basis rancher) has $100 more capital gain and an equal offsetting deduction of $100 against ordinary income. Since a taxpayer can elect to be taxed on one-half of his capital gain income, the cash basis taxpayer obtains a $100 deduction in exchange for $50 of income.

The reason for this disparity in the treatment of breeding cattle is largely historical. The cash basis was designed to afford an extremely simple method of accounting to ranchers (and farmers) by obviating the necessity of maintaining any inventory procedure at all. Before ranchers were entitled to capital gains on the sale of breeding cattle, the cash method merely resulted in the deduction of the costs of raising cattle at the time the outlays were made rather than in the later year when the cattle were sold (as under the accrual method), but in any event only ordinary income was affected. However, when Congress in 1951 granted capital gain treatment on the sale of breeding cattle,[7] cash basis taxpayers automatically

[7] The possibility of ranchers obtaining capital gain treatment for profits on sales of breeding cattle first arose in 1942 with the enactment of the predecessor of present Code § 1231(a) providing for capital gain on sales of "property used in the trade or business" (§ 117(j) of the 1939 Code,

received an unintended tax advantage from the transformation of ordinary income into capital gain. Although the Commissioner wished, at this point, to amend the regulations to require cash basis ranchers to accumulate the costs of raising breeders, a study of the legislative history of the 1951 amendment convinced the Treasury Department that Congress had precluded such a basic change in the cash method of accounting. Both Committee Reports had stated that capital "gains from sales of livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and *presently* recognized by the Bureau of Internal Revenue." S. Rep. No. 781, 82d Cong., 1st Sess., p. 42; H. Rep. No. 586, 82d Cong., 1st Sess., p. 32 (emphasis added). Therefore, in 1952 the Secretary of the Treasury informed Congress that the new capital gain provision, when considered in conjunction with the Treasury Regulations governing methods of accounting, had created a "windfall" for cash basis taxpayers on the sale of breeding animals (Letter of June 27, 1952, from the Secretary of the Treasury to the Chairman of the Senate Finance Committee, 98 Cong. Rec., Pt.

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added by § 151(b) of the Revenue Act of 1942, 56 Stat. 798). The first court of appeals decision upholding the claimed capital gain treatment for breeding cattle was in 1949 (*Albright* v. *United States*, 173 F. 2d 339 (C.A. 8)), and Congress amended the Code in 1951 to explicitly provide for capital gain treatment on breeders held 12 months or more. (Revenue Act of 1951, § 324, 65 Stat. 452; see generally *United States* v. *Ekberg*, 291 F. 2d 913, 916, fn. 5, 919-920 (C.A. 8), certiorari denied, 368 U.S. 920).

6, pp. 8307-8308, reprinted Catto R. 11-19). Although the Secretary's letter stated that legislation was necessary to eliminate this unwarranted benefit to cash basis taxpayers, Congress did not act. In fact, two years later when the 1954 Code was enacted, the provision for breeding cattle was retained verbatim (as Section 1231).

In short then, the accrual basis rancher is required by regulation to accumulate (*i.e.*, capitalize) the costs of raising breeding animals and, upon sale, report as capital gain only the excess of sales proceeds over cost basis. This is consistent with the tax treatment of capital assets in other types of profit-making enterprises. The cash basis rancher, on the other hand, receives an unwarranted tax windfall, because he deducts against ordinary income the full costs of raising breeding animals (thus giving him a zero cost basis in the breeders) and upon sale replaces this previous reduction in ordinary income with an equal amount of capital gain. While the Treasury Department has thus far been unsuccessful in closing this loophole for the cash basis rancher, it does not follow that an accrual basis rancher must be allowed the same windfall. The legislative history and statutory reenactment which prevent the Secretary of the Treasury from amending the regulations relating to cash basis ranchers also give the effect of law to the long-standing and explicit regulations requiring accrual basis ranchers to capitalize the costs of raising breeding cattle. *Brewster* v. *Gage*, 280 U.S. 327, 337; *Helvering* v. *Winmill*, 305 U.S. 79, 83; *Boehm* v. *Commissioner*, 326 U.S. 287, 291-292. Since

the accrual rancher has elected to capitalize the costs of raising his animals, it would be incongrous indeed to permit him to dispense with this practice as to his breeding herd while requiring him to maintain it as to his beef herd. See *Little* v. *Commissioner*, 294 F. 2d 661, 663-664 (C.A. 9). Nevertheless, that is exactly what the Fifth Circuit has done in the instant cases by holding invalid the Treasury Regulation requiring accrual basis ranchers to capitalize the costs of raising breeding animals.

3. A material revision in the method of treating raised breeding livestock is clearly a change in taxpayers' "method of accounting" and thus requires the "consent of the Secretary or his delegate." Internal Revenue Code of 1954, § 446(e), App. B, *infra*, p. 36; Treas. Reg. § 1.446-1(e)(2)(i), App. B, *infra*, pp. 40-41; *United States* v. *Ekberg*, 291 F. 2d 913 (C.A. 8), certiorari denied, 368 U.S. 920; cf. *Carter* v. *Commissioner*, 257 F. 2d 595 (C.A. 5); *Irvine* v. *United States*, 212 F. Supp. 937 (D. Wyo.). None of the taxpayers in the instant cases had ever applied to the Commissioner for such a change in their method of accounting. Nevertheless, the Fifth Circuit held that the material revision in accounting for breeding cattle which these taxpayers asked the court to grant (and which the court did grant) did not constitute a "change in accounting method which necessitates the consent of the Commissioner . . ." and thus excused their failure to apply for permission to change.[8] *United States* v. *Catto*,

[8] The Commissioner has generally denied ranchers' requests to change from the accrual to the cash method of ac-

App. A, *infra*, p. 21.

Moreover, the court below permitted the taxpayers to take an immediate deduction for the full accumulated cost basis of all raised breeding animals on hand, although the court explicitly recognized that this would give them "an inordinate deduction against ordinary income in the year in which the correction is made." *United States* v. *Catto*, App. A, *infra*, p. 21. Under these decisions the taxpayers will thus be in the anomalous position of capitalizing the costs of all beef cattle and of purchased breeding cattle while taking an immediate deduction for the costs of raising breeding cattle. See *Carter* v. *Commissioner*, 257 F. 2d 595; *United States* v. *Wardlaw*, App. A, *infra*, pp. 24-25. The twofold effect of this hybrid method of accounting will be, first, to give the taxpayers an inordinately large deduction against ordinary income

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counting except for ranchers with very small herds. Where large herds are involved the accrual method provides a much clearer and more accurate reflection of income. Therefore, the Commissioner has denied requests where the only reason for the change was to obtain the tax windfall presently permitted to cash basis taxpayers and no valid business reason was demonstrated. This policy, we submit, does not constitute an abuse of the Commissioner's broad discretion to insure that taxpayers use methods of accounting that accurately reflect income. At all events, since none of the instant taxpayers applied to the Commissioner for permission to change to the cash basis, or made any attempt to show any business reason for the change, they are not in a position to challenge the Commissioner's actions in denying the requests of other taxpayers. Finally, the court's decisions did not put the taxpayers on the cash basis, but on an unprecedented hybrid method of accounting which does not clearly reflect their incomes.

in the year of the change, and thereafter to permit them to transform ordinary income into capital gain by using a zero basis in computing capital gains.

CONCLUSION

There is a clear conflict among the courts of appeals. The question, moreover, potentially affects large numbers of taxpayers and will have a substantial impact upon the revenue. Accordingly, we respectfully submit that this petition for certiorari should be granted.

THURGOOD MARSHALL,
Solicitor General.

JOHN B. JONES, JR.,
Acting Assistant Attorney General.

JACK S. LEVIN,
Assistant to the Solicitor General.

MELVA M. GRANEY,
MARTIN T. GOLDBLUM,
Attorneys.

SEPTEMBER 1965

APPENDIX A

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 21351

UNITED STATES OF AMERICA, APPELLANT

versus

JOHN CATTO, JR., and ROXANA CATTO, his wife,
APPELLEES

Appeal from the United States District Court for the Western District of Texas

(April 8, 1965.)

Before GEWIN and BELL, Circuit Judges, and MCRAE, District Judge.

PER CURIAM: This appeal raises once again the problem of the tax and accounting treatment to be accorded raised breeding cattle which are sold by an accrual basis taxpayer.[1] The appellees, who are owners and operators of two cattle ranches in West Texas, keep their books on the accrual basis and file their tax returns accordingly.

Taxpayers, in conformity with Treasury regulations,[2] have chosen to value their inventory by the

[1] The identical issue is raised in United States v. Wardlaw, No. 21607, ... F.2d . . . ., decided this day.

[2] Treas. Reg. 1.471-6(c).

unit-livestock-price method. If this method is used, standard unit values are assigned to different classes of animals within the herd, representing estimated rather than actual expenses of raising each animal, and standard increments are added to closing inventory each year. Under Treas. Reg. 1.471-6(f), a taxpayer who elects to use the unit-livestock-price method of valuing his inventory must apply it to all of his *raised* livestock, whether they are held for sale or for breeding purposes. Hence, an accrual taxpayer who employs the unit-livestock-price method must include his raised breeding cattle in inventory along with his cattle held for sale, although the breeding cattle may be taxed at capital gains rates upon sale.[3]

Prior to and during the taxable years in question, the taxpayers complied with Treas. Reg. 1.471-6(f). They removed the raised breeding cattle which they sold from opening and closing inventory for the year of sale and paid a capital gains tax on the sales, using the inventory value under the unit-livestock-price method as the basis for computing the gain on the sale of each animal.

Taxpayers then instituted this suit for refund in the district court, contending, on the basis of our decision in *Scofield* v. *Lewis*, (5 Cir. 1958) 251 F.2d 128, that Treas. Reg. 1.471-6(f) is invalid and that they may therefore correct the erroneous inclusion of raised breeding cattle in inventory by removing all such cattle from closing inventory. This procedure, in effect, affords them a deduction of the estimated raising costs against ordinary income, but they must compute the gain on the sale of these cattle on a zero basis. The net effect of this transaction is to substitute a deduction against ordinary income for

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[3] 26 U.S.C.A. § 1231(b)(3).

a deduction against capital gains. The district court, following *Scofield*, ruled in favor of the taxpayers.

The Government challenges the propriety of applying the *Scofield* rationale, urging that the requirement that raised breeding cattle be inventoried is merely a convenient means of capitalizing the cost of such cattle until the time of sale and, as such, is a valid exercise of the Commissioner's power to prescribe accounting methods which accurately reflect income. The taxpayers, on the other hand, note the discriminatory effect of this requirement on accrual taxpayers, since the Treasury has long indulged similar cash basis taxpayers by allowing them to write off the raising costs of breeding cattle against ordinary income and compute their capital gain on the sale of such cattle on a zero basis. They argue that *Scofield* was correct in holding that Treas. Reg. 1.471-6(f) is inconsistent with section 1231(b)(3), which accords all breeding cattle capital gains treatment. While we are fully cognizant of the anomaly of allowing such tax treatment of a capital asset and appreciate the appealing conceptual arguments of the Government, we regard *Scofield* as controlling until its legislative or judicial demise.[4]

Since *Scofield* governs on the issue of the invalidity of Treas. Reg. 1.471-6(f), we think the taxpayer is justified in correcting the error which the regula-

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[4] We are also aware of the fact that the two Circuits that have examined the problem since the *Scofield* decision have refused to follow it, see Little v. Commissioner (9 Cir. 1961) 294 F.2d 661; United States v. Ekberg (8 Cir. 1961) 291 F.2d 913, *cert. denied*, 368 U.S. 920, 7 L.Ed.2d 135, and that this Court has severly limited its applicability, see Carter v. Commissioner (5 Cir. 1958) 257 F.2d 595, which relates to purchased breeding animals inventoried on the farm-price method.

tion imposed by the procedure which he suggests, even though it results in an inordinate deduction against ordinary income in the year in which the correction is made. Moreover, we do not deem this a change in accounting method which necessitates the consent of the Commissioner, particularly in view of the consistent refusal of the Commissioner, during the years in question, to entertain applications by accrual basis cattle ranchers to change to the cash method of accounting for tax purposes.[5]

Accordingly, the judgment is AFFIRMED.

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[5] It was stipulated that during the years 1954-1958, the Commissioner refused to consider ranchers' requests to change from accrual accounting methods to the cash receipts and disbursements method. A similar situation obtained during the years 1946-1949, as indicated by *Scofield* v. *Lewis*, 251 F.2d at 131. The taxpayer, therefore, feels he cannot escape from the "Box" in which his election has placed him.

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

Before GEWIN and BELL, *Circuit Judges, and* MCRAE, District Judges.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

April 8, 1965

Issued as Mandate: May 3, 1965

IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 21607

UNITED STATES OF AMERICA, APPELLANT-APPELLEE

versus

W. H. WARDLAW, Independent Executor of the Estate of C. H. Wardlaw, Deceased, ET AL, APPELLEES-APPELLANTS.

(AND REVERSE TITLE)

Appeals from the United States District Court for the Western District of Texas.

(April 8, 1965.)

Before MARIS,* RIVES and BROWN, Circuit Judges.

PER CURIAM: This appeal and cross appeal presents Taxpayer's and the Government's dissatisfaction with the trial Court's disposition of the tax refund suit. We affirm.

At issue is the proper income tax treatment of *raised* breeding animals and *purchased* breeding animals owned by an accrual basis Taxpayer-Rancher.

The Government's appeal concerns *raised* breeding

* Of the Third Circuit, sitting by designation.

animals.[1] The District Court followed our opinion in *Scofield* v. *Lewis*, 1958, 251 F.2d 128, which held that Treasury Regulation 1.471-6(f) was invalid. Despite the doubts generated by express rejection of *Lewis* by the 8th and 9th Circuits,[2] a somewhat restricted reading of it by us in *Carter* v. *Commissioner*, 5 Cir., 1958, 257 F.2d 595, and the impressive conceptual arguments perhaps not fully advanced earlier, we recognize that *Lewis* is directly in point and is, and must be, controlling until the principle is judicially reversed or legislatively repealed.[3]

The Taxpayer's appeal concerns *purchased* breeding animals. Accrual basis livestock farmers under Treas. Reg. 1.471-6(g) (1954 Code) are given an option to include in inventory their purchased breeding animals, or to treat them as capital assets subject to de-

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[1] The same issue is now pending before another panel of this Court in United States v. Catto, No. 21351, 1965, ... F.2d . . . . .

[2] United States v. Ekberg, 8 Cir., 1963, 291 F.2d 913; Banks v. Commissioner, 8 Cir., 1963, 322 F.2d 530, 546-47; Little v. Commissioner, 9 Cir., 1963, 294 F.2d 661; see also Irvine v. Commissioner, D.C. Wyo., 1963, 212 F.Supp. 937.

[3] Congress, at least since 1952, has been aware of many of these problems. See letter of June 27, 1952, from Secretary of the Treasury to Senator George, Chairman of the Senate Finance Committee, 98 Cong. Record, part 6, pp. 8307-8308. One complicating factor is the practice, recognized by formal regulations by which both accrual and cash basis taxpayers may deduct the cost of feeding, raising and maintaining animals as ordinary and necessary business expense rather than treating them as capital expenditure for the "acquuisition" of a capital asset, i.e., a mature animal. Treasury Regulation 1.162-12. This regulation, with only slight terminology changes, goes back to 1921. See, e.g., Regulation 45, Art. 110, for the year 1921; Reg. 101, Art. 23(a)-11, for the year 1936.

preciation. Taxpayer here, prior to 1957, had been including purchased animals in inventory, but, without the Commissioner's consent, elected in the years 1957, 1958, 1959 to exclude purchased animals from inventory so as to (a) depreciate their cost basis and (b) upon sale report capital gain against depreciated cost rather than inventory value. The District Court sustained the Commissioner's refusal to permit this.

The difference between Taxpayer and the Government is a narrow one. Taxpayers recognize that the option has to be exercised and that once exercised as to a particular animal, that animal cannot be changed from inventory to depreciable asset, or vice versa. The Government urges that it is the practice with respect to the herd. We agree.

The Regulations, § 1.61-4(b)[4] require a consistency from year to year and as such represent a valid exercise of the Commissioner's power to prescribe reasonable accounting methods. *Cf. Carter* v. *Commissioner*, 5 Cir., 1958, 257 F.2d 595. We are not impressed with Taxpayer's argument that it was 1960 before it was learned for the first time that only one election is afforded. The Regulation is plain and administratively reasonable. "There is no evidence that Ruling 60-60 departed from any prior construction of the applicable statutes and regulations." *Tee Bar Ranch Co.* v. *United States*, D. Mont., 1963, 63-2 USTC #9663, at 89,681 and authority there collected.

AFFIRMED.

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[4] § 1.61-4(b). "A farmer using accrual method of accounting must use inventories to determine his gross income * * *. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory * * * instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. * * *."

JUDGMENT

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

Before MARIS,* RIVES and BROWN, Circuit Judges.

This cause came on to be heard on the transcript of the record from the United States District Court for the Western District of Texas, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

April 8, 1965

Issued as Mandate: May 3, 1965

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* Of the Third Circuit, sitting by designation.

IN THE

UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 16709

FRANK SCOFIELD, Collector of Internal Revenue, APPELLANT

versus

A. J. LEWIS and GRACE M. LEWIS, APPELLEES

Appeal from the United States District Court for the Western District of Texas

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(January 20, 1958.)

Before CAMERON, JONES and WISDOM, Circuit Judges.

JONES, Circuit Judge: The appellees, A. J. Lewis and Grace M. Lewis, husband and wife, were members of a partnership which conducted to ranching operations in West Texas. They will be called taxpayers in this opinion. For Federal income tax reporting the taxpayers were on a cash basis and the partnership was on an accrual basis. The partnership's operation was organized for the purpose of breeding high quality cattle and sheep. From year to year the partnership sold the steer calves and the mutton sheep produced by its breeding herd. It also sold, from time to time, from its breeding herd, when

required by age, disease, drought or other necessitous circumstance, some of its cows and ewes as well as some of the bulls and bucks, and heifers which were unfit for breeding stock or which could not, for some other reason, be retained. During the tax years here involved, 1946 through 1949, no animals were sold which had not been held for six months except baby calves which were, of necessity, sold with their mothers. Operating on an accrual basis, the partnership carried its livestock which it raised for the markets on an inventory basis and these animals were valued under the unit-livestock-price method. For 1939 and years subsequent, including the years 1946 through 1949 here involved, the breeding stock was carried on the inventory. This was done in compliance with the Commissioner's Regulation which provided that "A taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes." Under the unit-livestock-price method heifers were valued by the partnership at $40, yearlings at $45, two-year-olds at $50, and three-year-olds and over at $55, with the annual inventory increases treated as ordinary income. Ewe lambs were given similar treatment. The taxpayers returned their gains on the sales of breeding stock through 1949 as ordinary income.

In 1949 there appeared three tax decisions, *Albright* v. *United States*, 8th Cir. 1949, 173 F. 2d 339; *Emerson* v. *Commissioner*, 12 T. C. 875; and *Fawn Lake Ranch Co.* v. *Commissioner*, 12 T. C. 1139, appeal dismissed 180 F. 2d 749, each holding upon the particular facts of the case that sales of breeding herd animals were entitled to capital gains treatment for tax purposes. The taxpayers filed claims for refunds for the years 1946 through 1949 claiming the

difference between the tax they had paid on profits from sales of breeding stock at ordinary income rates and the amount they would have paid, by their computation, on a capital gains basis. Before the Commissioner had acted upon the claim for refund the pertinent provision of the applicable Revenue Act had been amended. Section 117 of the Act, 26 U.S.C.A. (I.R.C. 1939) § 117(j), excludes from capital gains tax treatment, among other things "property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year". In the Revenue Act of 1951, 65 Stat. 452, the following was included (at 501):

> "Section 117(j)(1) is hereby amended by adding at the end thereof the following new sentences: 'Such term [property used in the trade or business] also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.' The first sentence added to section 117(j)(1) by the amendment made by this section shall be applicable with respect to taxable years beginning after December 31, 1941, except that the extension of the holding period from 6 to 12 months shall be applicable only with respect to taxable years beginning after December 31, 1950. The second sentence added to section 117(j)(1) by the amendment made by this section shall be applicable only with respect to taxable years beginning after December 31, 1950."

The Regulations promulgated by the Commissioner contained the following provisions:

"Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided adjustments are made in accordance with one of the two methods outlined in (1) and (2) below. It is optional with the taxpayer which method is used, but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method be authorized by the Commissioner.

* * * *

"A taxpayer who elects to use the 'unit-livestock-price method' must apply it to all livestock raised, whether for sale or for breeding, draft, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner." Treas. Reg. 111, § 29.22 (c)-6, as amended by T. D. 5423, 1945 C. B. 70.

By another Regulation the Commissioner directed that "in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method." The same regulation requires that "A taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner", and that "a change in the method of accounting means * * * a change from cash receipts to the accrual method, or vice versa", or a change involving

the basis of valuation employed in the computation of inventories. Treas. Reg. 111, § 29.41-2.

On May 19, 1953, following the amendment to Section 117(j), the Commissioner acted upon the refund claims, recognized that the sales of breeding stock were entitled to capital gains treatment, allowed the claims in part, disallowed them in part, and assessed tax deficiencies for 1946 and 1949. The taxpayers sued for the amount of their claim which had been disallowed. The district court held that the proceeds of baby calves sold with their mothers should be taxed as ordinary income and $10 of the price of the pair was allocated as the price of the calf. No question is before us with respect to the tax incidents of the sale of the calves. The district court resolved the other questions for the taxpayers and entered judgment against the Collector, from which judgment he has appealed. Before the district court it was claimed by the Government, as it is claimed before us, that the taxpayers were on a unit-livestock-price inventory accrual basis and that they could not, under the regulations, change from such basis to a cash basis and take the breeding stock out of the inventory without the consent of the Commissioner. Therefore, the Government says, the taxpayers are entitled to a capital gain measured by the difference between the accrued cost basis attributable to the breeding stock sold and the sales proceeds. The district court held that the taxpayers were entitled to a capital gain on the entire purchase price. In the court's findings of fact it was recited:

> "The uncontroverted evidence shows and the Court finds that (i) such approval [of a change in accounting methods and inventory practices] could not have been obtained for the years involved because they had already passed when the

> issue arose (following the Albright decision in 1949) and (ii) the Commissioner had refused to consider and approve any such application until his Bureau Release of May 12, 1953, and (iii) that plaintiffs in their claims for refund and in the administrative hearings were seeking the right to correct a mistake by simply removing a capital asset that, under the terms of Section 117(j) could not be the subject matter of an inventory, and which should never have been in the inventory in the first place."

The district court held that the portions of Regulations 29.22 (c) which require the inclusion of breeding stock in a ranch inventory were in conflict with Section 117(j) and hence invalid, and that no change of accounting method was involved and therefore neither the approval nor consent of the Commissioner is required. The sole issue we are to determine is whether the cost basis to be used in computing the capital gain on breeding stock sold is zero, as the taxpayers claim, or a basis accrued under the unit-livestock-price method of inventory valuation, for which the Government contends.

In 1944 the Commissioner ruled that the cost basis of stock of a breeding herd of a taxpayer on a cash receipts and disbursements basis had a zero cost on such livestock, but as to a taxpayer on an accrual basis the accrued inventory basis would be regarded as cost. By this ruling it was said that animals culled from a breeding herd as feeder or slaughter animals would not be treated as capital assets. I. T. 3666, 1944 C.B. 270. In the following year the Commissioner undertook to define animals "culled from the breeding herd" as including stock "which due to injury, age, disease or any other reasons (other than that of changing the breed or the quality of the offspring)

are no longer desired by the livestock raiser for breeding purposes, and also the normal selection for sale of animals for the purpose of maintaining the herd at a regular size." I.T. 3712, 1945 C.B. 176. Two years later, on August 4, 1947, the Commissioner wrote a member of the Senate that "culls" would include all animals sold in excess of the animals added to the herd as long as the herd was held at normal size, and sales of culls would give rise to ordinary income. 1948 C.C.H. Par. 6091.

The resentment of stock breeders and dairymen at the Commissioner's efforts to restrict their capital gains treatment found its first reported expression in *Albright* v. *United States, supra,* from the Eighth Circuit. The Tax Court soon followed with its decisions in *Emerson* v. *Commissioner, supra,* and *Fawn Lake Ranch Co.* v. *Commissioner, supra.* In the Fawn Lake case the taxpayer used the unit-livestock-price inventory accrual method. The Tax Court held that the taxpayer using an inventory basis was no less entitled to capital gains treatment than was a taxpayer on a cash basis as in the Albright case. The cost basis used in the Fawn Lake case was the accrued inventory figure which was what the taxpayer there had contended for. *Flato* v. *Commissioner,* 14 T. C. 1241, affirmed on other grounds 195 F. 2d 580, and *Kline* v. *Commissioner,* 15 T.C. 998, had only the factual questions of whether the particular sales were of breeding stock. In 1951, in a consolidation of five appeals, this court held that notwithstanding the I. T. rulings, stock breeders were entitled to capital gains treatment of animals culled from the herd where the usefulness of the animals had been lost and this regardless of the effect of the sales on the size of the herd. *United States* v. *Bennett,* 5th Cir. 1951, 186 F. 2d 407. We find no reported case on the question

which arose subsequent to the 1951 amendment to § 117(j).

The Government cites authority for the proposition that the Commissioner has power to prohibit the change of accounting methods by a taxpayer without the Commissioner's consent. *Ross B. Hammond, Inc.* v. *Commissioner*, 9th Cir. 1938, 97 F. 2d 545; *Jones* v. *Smith*, 10th Cir. 1951, 193 F. 2d 381; *Advertisers Exchange, Inc.* v. *Commissioner*, 25 T.C. 1086, affirmed 240 F. 2d 958. There are, though, other rules with respect to the effect of the Commissioner's Regulations. The Regulations must, by their terms and in their application, be in harmony with the statute. A Regulation which is in conflict with or restrictive of the statute is, to the extent of the conflict or restriction, invalid. A Regulation, valid when promulgated, becomes invalid upon the enactment of a statute in conflict with the Regulation. The only authority conferred, or which could be conferred, upon the Treasury Department is to make regulations to carry out the purposes of the statute. *Miller* v. *United States*, 294 U. S. 435, 55 S. Ct. 440, 79 L. Ed. 977, rehearing denied 294 U. S. 734, 55 S. Ct. 635, 79 L. Ed. 1262; *Newman* v. *Commissioner*, 5th Cir. 1935, 76 F. 2d 449, cert. den. 296 U. S. 600, 56 S. Ct. 116, 80 L. Ed. 425.

A taxpayer in the business of raising cattle who maintained breeding stock as well as a herd raised for sale could not, under the Regulations, elect to use the unit-livestock-price method of inventory values as to the herd raised for sale without using the same method as to the breeding animals and thus be required to use an accrued basis as cost upon making sales. As to a taxpayer who had commenced such procedure before the decision in the Albright case and those subsequent to it, the Commissioner insisted that

the unit-livestock-price inventory accruals be continued until his consent was given to a change, and at the same time refused to consider any applications to remove the breeding stock from the inventories. This, we think, was not what the Congress intended. We find nothing in the 1951 amendment to Section 117 (j), or for that matter in the Section as originally passed, indicating a Congressional design to limit the extent of capital gains treatment accorded to taxpayers selling animals from a breeding or dairy herd because of their prior election to use the unit-livestock-price method. The problem involves accounting practices and, to be sure, methods of accounting in some circumstances may be determinative of tax liability, but such is not the case here. Animals in a breeding herd are capital assets and no cogent reason appears why one group of taxpayers should be allowed the full benefits of the capital gains provisions by the use of a zero basis and others should be limited to a basis measured by the accrual under an inventory method which a regulation unreasonably required be used as to breeding stock if it was to be used as to animals raised for sale. The intent of the Congress, as we discern it, in the enactment of the 1951 amendment to Section 117(j) is otherwise. The amendment clearly and unequivocally says that livestock held for breeding purposes is property used in the trade or business of the taxpayer. As to such livestock the taxpayers were not required to include them in an inventory or to use a unit-livestock-price method to determine the cost basis of animals sold. *Cf. Schafer* v. *Helvering*, 299 U.S. 171, 57 S. Ct. 148, 81 L. Ed. 101.

We are in accord with the result reached by the District Court. Its judgment is

AFFIRMED.

APPENDIX B

Internal Revenue Code of 1954:

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

* * * *

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

(26 U.S.C. 1964 ed., Sec. 446.)

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) *General Rule.*—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. * * *

* * * *

(b) *Definition of Property Used in the Trade or Business.*—For purposes of this section—

* * * *

(3) *Livestock.*—Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

* * * *

(26 U.S.C. 1964 ed., Sec. 1231.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.61-4 *Gross income of farmers.*

(a) *Farmers using the cash method of accounting.* A farmer using the cash receipts and disbursements method of accounting shall include in his gross income for the taxable year—

(1) The amount of cash and the value of merchandise or other property received during the taxable year from the sale of livestock and produce which he raised,

(2) The profits from the sale of any livestock or other items which were purchased,

(3) All amounts received from breeding fees, fees from rent of teams, machinery, or land, and other incidental farm income,

(4) All subsidy and conservation payments received which must be considered as income, and

(5) Gross income from all other sources.

The profit from the sale of livestock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the

year in which the sale occurs, except that in the case of the sale of purchased animals held for draft, breeding, or dairy purposes, the profits shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation allowed or allowable (determined in accordance with the rules applicable under section 1016(a) and the regulations thereunder). * * *

(b) *Farmers using an accrual method of accounting.* A farmer using an accrual method of accounting must use inventories to determine his gross income. His gross income on an accrual method is determined by adding the total of the items described in sub-paragraphs (1) through (5) of this paragraph and subtracting therefrom the total of the items described in sub-paragraphs (6) and (7) of this paragraph. These items are as follows:

(1) The sales price of all livestock and other products held for sale and sold during the year;

(2) The inventory value of livestock and products on hand and not sold at the end of the year;

(3) All miscellaneous items of income, such as breeding fees, fees from the rent of teams, machinery, or land, or other incidental farm income;

(4) Any subsidy or conservation payments which must be considered as income;

(5) Gross income from all other sources;

(6) The inventory value of the livestock and products on hand and not sold at the beginning of the year; and

(7) The cost of any livestock or products purchased during the year (except livestock held

for draft, dairy, or breeding purposes, unless included in inventory).

All livestock raised or purchased for sale shall be added in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Livestock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory (see subparagraphs (2), (6), and (7) of this paragraph) instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently from year to year by the taxpayer. When any livestock included in an inventory are sold, their cost must not be taken as an additional deduction in computing taxable income, because such deduction is reflected in the inventory. See the regulations under section 471. * * *

* * * *

§ 1.162-12 *Expenses of farmers.*

* * * The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. * * * Amounts expended in purchasing work, breeding, or dairy animals are regarded as investments of capital, and shall be depreciated unless such animals are included in an inventory in accordance with § 1.61-4. * * *

* * * *

§ 1.167(a)-6 *Depreciation in special cases.*

* * * *

(b) *Depreciation in cases of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. See also section 162 and the regulations thereunder relating to trade or business expenses, section 165 and the regulations thereunder relating to losses of farmers, and section 175 and the regulations thereunder relating to soil or water conservation expenditures.

* * * *

§ 1.446-1 *General rule for methods of accounting.*

* * * *

(e) *Requirement respecting the adoption or change of accounting method.* * * *

(2) (i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from

which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

* * * *

§ 1.471-6 *Inventories of livestock raisers and other farmers.*

(a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Commissioner as provided in paragraph (e) of § 1.446-1.

(b) In any change of accounting method from the cash receipts and disbursements method to an inventory method, adjustments shall be made as provided in section 481 (relating to adjustments required by change in method of accounting) and the regulations thereunder.

(c) Because of the difficulty of ascertaining actual cost of livestock and other farm products, farmers who render their returns upon an inventory method may value their inventories according to the "farm-price method", and farmers raising livestock may value their inventories of animals according to either the "farm-price method" or the "unit-livestock-price method".

(d) The "farm-price method" provides for the valuation of inventories at market price less direct cost of disposition. If this method of valuing inventories is used, it must be applied

to the entire inventory except as to livestock inventoried, at the taxpayer's election, under the "unit-livestock-price method". If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of valuing inventories from that employed in prior years, permission for such change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1.

(e) The "unit-livestock-price method" provides for the valuation of the different classes of animals in the inventory at a standard unit price for each animal within a class. A livestock raiser electing this method of valuing his animals must adopt a reasonable classification of the animals in his inventory with respect to the age and kind included so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes. Thus, if a cattle raiser determines that it costs approximately $15 to produce a calf, and $7.50 each year to raise the calf to maturity, his classifications and unit prices would be as follows: Calves, $15; yearlings, $22.50; 2-year olds, $30; mature animals, $37.50. The classification selected by the livestock raiser, and the unit prices assigned to the several classes, are subject to approval by the district director upon examination of the taxpayer's return.

(f) A taxpayer who elects to use the "unit-livestock-price method" must apply to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent

taxable years in the valuation of livestock inventories. No changes in the classification of animals or unit prices will be made without the approval of the Commissioner.

(g) A livestock raiser who uses the "unit-livestock-price method" must include in his inventory at cost any livestock purchased, except that animals purchased for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or be treated as capital assets subject to depreciation after maturity. If the animals purchased are not mature at the time of purchase, the cost should be increased at the end of each taxable year in accordance with the established unit prices, except that no increase is to be made in the taxable year of purchase if the animal is acquired during the last six months of that year. If the records maintained permit identification of a purchased animal, the cost of such animal will be eliminated from the closing inventory in the event of its sale or loss. Otherwise, the first-in, first-out method of valuing inventories must be applied.

(h) If a taxpayer using the "farm-price method" desires to adopt the "unit-livestock-price method" in valuing his inventories of livestock, permission for the change shall first be secured from the Commissioner as provided in paragraph (e) of § 1.446-1. However, a taxpayer who has filed returns on the basis of inventories at cost, or cost or market, whichever is lower, may adopt the "unit-livestock-price method" for valuing his inventories of livestock without formal application for permission, but the classifications and unit prices selected are subject to approval by the district director upon examination of the tax-

payer's return. A livestock raiser who has adopted a constant unit-price method of valuing livestock inventories and filed returns on that basis will be considered as having elected the "unit-livestock-price method".

(i) If returns have been made in which the taxable income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding taxable year. In this statement such adjustments shall be made as are necessary to bring the closing inventory for the preceding taxable year into agreement with the opening complete inventory for the current taxable year. If necessary clearly to reflect income, similar adjustments may be made as at the beginning of the preceding year or years, and the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such year or years.

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